Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMD:DEN:TL-N-2884-99
WRDavis

date:

to: Case Manager E:2:9
Rocky Mountain District

from: District Counsel, Rocky Mountain District, Denver

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subject: **Request for District Counsel Assistance**
Taxpayer: [redacted] & subs.
Tax years: [redacted] through [redacted], inclusive

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Reference is made to your memorandum wherein you seek our views on the issues presented by the second supplemental protest of [redacted] and subsidiaries ("taxpayer") on the issue of investment tax credit. Specifically, you seek advice regarding the taxpayer's claim for investment tax credit for [redacted] for property that they contend qualifies as "transition property" under I.R.C. § 49 (1986) because it meets the tests for

self-constructed property set forth at section 203(b)(1)(B)[1] of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 ("the Act"). This claim relates solely to the taxpayer's costs incurred in connection with its provision of [redacted] ("MFJ"). Additionally, your memorandum asked us to identify any additional facts that you may wish to develop for your examination of these issues. As set forth below, we conclude that your position correctly resolves this issue.

ISSUES

1. [redacted] constitute self-constructed property, as defined in Act section 203(b)(1)(B), as modified by section 49(e)(1)(B)[2], and thus qualify for investment tax credit as transition property under section 49(e) for the tax years at issue?

2. What is the applicable date by which the taxpayer was required to place in service the property for which it seeks investment tax credit?

3. What additional factual development is required to better clarify the bona fides of the taxpayer's claim?

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[1] Hereinafter all references to sections of the Tax Reform Act of 1986 are referred to as "Act section," and all references to Internal Revenue Code sections are referred to as "section."

[2] Section 11812(a) of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, replaced the version of Code section 49 included in the Tax Reform Act of 1986. The transition rules contained therein excepted, inter alia, any transition property as defined in old section 49(c) from the change. Pub. L. No. 101-508, § 11813(c)(2)(A). Except as otherwise noted, all references to section 49 herein refer to that section prior to changes made by the Omnibus Budget Reconciliation Act of 1990.

CONCLUSIONS

1. Based upon the facts presented, the property constructed by the taxpayer in accordance with its [redacted] does not qualify as a self-constructed asset, as used in the transition rules of the Tax Reform Act of 1986.

2. [redacted] placed it in service was January 1, 1987, which was prior to the claim years. [redacted] the applicable date was January 1, 1991.

3. We recommend that you gather additional information concerning the portions of the taxpayer's [redacted] that were placed in service during the claim years, and date on which significant work started on such properties, and for such properties, the amount expended or committed by the taxpayer prior to 1986.

FACTS

The taxpayer, [redacted] and subsidiaries, filed amended returns (Forms 1120X) for the taxable years [redacted], [redacted] and [redacted]. For these years, the taxpayer claimed additional investment credits in the amounts of $[redacted], $[redacted], and $[redacted], based upon its contention that "underlying property generating the credit constituted transition property within the meaning of section 49(e)."

In its [redacted], "Supplement to Supplemental Protest Dated [redacted]" ("Second Supplemental Protest"), the taxpayer asserts, as an alternative basis for the eligibility of the capital improvements required to comply with the [redacted] for the investment tax credit, that such property constituted self-constructed property within the meaning of Act sections 203(b)(1)(B) and 211(a), which added section 49.[3]

The taxpayer, without dispute, states that it had "considerable property used in the provision of [redacted] in place prior to December 31, 1985." This included [redacted]

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[3] Additionally, the taxpayer has expressed its intent to base a claim for all [redacted] property it placed in service prior to January 1, 1991, as self-constructed property within the meaning of Act section 203(b)(1)(B) and section 49(e).

[redacted]. However, other than describing the components of its network that it claims all fall within the definition of "property," as used in Act section 203(b)(1)(B), the taxpayer fails to identify each separate property that it claims qualify as transition property under section 49(e) by their specific type, the amount expended, the date on which they were placed in service, or any other measure. In fact, the taxpayer makes evident its position that the entire [redacted] stands as the property whose post-1985 costs qualify as transition property through its statement concerning its satisfaction of the minimum expenditure/commitment requirement in Act section 203(b)(1)(B)(i):

> There can be no genuine dispute that [redacted] annually expended [redacted] of $[redacted] before 1986 in constructing or reconstructing its [redacted] for the provision of [redacted].

Second Supplemental Protest, at 4, ¶ I.B.

From further discussions with the audit team, we understand that the taxpayer's practice during the years at issue was to add [redacted] property to its rate base as the component properties (i.e., [redacted], etc.) become available for providing service, as well as to capitalize such property based upon this "placed in service" date. [redacted]. Moreover, we understand that a significant portion of the expenditures made by the taxpayer are budgeted for, approved by varying levels of corporate review, and tracked as jobs known as "specific estimates" or estimates. However, your discussions with the taxpayer disclose that it does not wish to base this claim on any estimates for which particular discrete additions to the [redacted], such as individual [redacted], could possibly qualify under Act section 203(b)(1)(B) as transition property.

Finally, we note that the taxpayer's description of its [redacted] facilities includes three distinct segments: (1) the [redacted], (2) the [redacted] to and including the [redacted], and (3) the [redacted]. It is not clear whether, or the extent to which, any portions of these segments

of its [redacted] facilities are included in the portion of the claim relating to [redacted].

ANALYSIS

1. Section 211(a) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, added section 49 to the Code. In general, this section repealed the investment tax credit ("ITC") for property placed in service after December 31, 1985. Section 49(a). Prior to the change in the law, section 46 generally allowed taxpayers a credit against their income tax liability for up to 10 percent of the investment in certain tangible depreciable property. The repeal was subject to certain transition rules, however. Among other things, section 49(b) excepts the applicability of section 49(a) to transition property, as defined in section 49(e).

In general, section 49(e)(1) defines transition property as "any property placed in service after December 31, 1985, and to which the amendments made by section 201 of the Tax Reform Act of 1986 do not apply." In applying this definition, however, section 49(e)(1) requires the following modifications relevant here:

(A) Act section 203(a)(1)(A) is applied by substituting "1985" for "1986", thus excluding all property placed in service after December 31, 1985, from treatment as transition property, unless otherwise excepted;

(B) Act sections 203(b)(1) and 204(a)(3) are applied by substituting "December 31, 1985" for "March 1, 1986", thus setting the last day of 1985 as the date by which the lesser of $1 million or 5 percent of the cost of a property had to have been incurred or committed to qualify such self-constructed property as transition property; and

(C) in the case of transition property with a class life of less than seven years, the applicable date by which a taxpayer had to place such property in service to receive transition property treatment, section 49(e)(1) specifies that

(i) Act section 203(b)(2) [specifying general requirements for "placed in service" dates] shall apply; and

(ii) in the case of property with a class life

(I) of less than 5 years, the applicable date shall be July 1, 1986, and

(II) at least 5 years, but less than 7 years, the applicable date shall be January 1, 1987.

Generally, this definition of transition property in section 49(e)(1) relies on the transition rules applicable to the accelerated cost recovery system (ACRS) in Act sections 203, 204, and 251(d), but substitutes the above earlier effective dates for the ones used for ACRS. In addition, Act section 203(b)(2) requires the taxpayer to place in service the property identified under one of the exceptions set forth in Act sections 203(b)(1) or 204(a) (other than Act sections 204(a)(8) through (a)(12)) prior to a specified date, referred to as the applicable date, determined, in general, by reference to the property's class life. Beyond the modification made by section 49(e)(1), which expands Act section 203(b)(2) to prescribe the applicable dates by which property with a class life of less than 7 years had to be placed in service to qualify for the credit, [redacted]

The taxpayer relies on the exception provided under Act section 203(b)(1)(B), as modified to require expenditure or commitment of certain amounts by December 31, 1985. That section, as modified, states that "section 201 shall not apply to property which is constructed or reconstructed by the taxpayer if the lesser of $1,000,000, or 5 percent of the cost of such property has been incurred or committed by [December 31, 1985][4], and the construction or reconstruction of such property began by such date." Under the stated terms of the exception, the taxpayer is entitled to an ITC only for the self-constructed property for which construction had begun by the end of 1985, and for which the expenditure or commitment levels were met. We note that, based upon your request, no dispute exists concerning the taxpayer's assertions that the property to which its claims relate were "self-constructed," as contemplated by the statute. Accordingly, we do not address this aspect of the claim.

Contractual Arrangements Before January 1, 1986

The taxpayer correctly states in its Second Supplemental Protest that the Act does not predicate eligibility of self-constructed property as transition property on the existence of

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[4] Section 49(e)(1)(B) provides that for transition property potentially eligible for the ITC, December 31, 1985, is to be substituted for the reference to March 1, 1986, in Act sections 203(b)(1) and 204(a)(3).

any type of contract. However, this ignores reference to contracts in the legislative history. The parenthetical language in the conference report explains that, for purposes of this exception, "committed" costs are those "required to be incurred pursuant to a written binding contract in effect" as of December 31, 1985. H.R. Rep. No. 841, 99th Cong., 2d Sess. at II-56, reprinted in 1986 U.S. Code & Cong. Ad. News 4144. To meet the 5 percent or $1 million pre-1986 commitment amounts, Congress required the existence of a written contract specifying that the taxpayer had to expend the lesser of these two amounts prior to 1986.

We understand that the taxpayer claims to have met the requirement of Act section 302(b)(1)(B)(i) by having incurred in excess of $1 million on the cost of the network prior to 1986. Nonetheless, the existence of plans as of the end of 1985 for post-1985 expenditures on property is not without importance, as the taxpayer seems to posit, and take on added meaning using a more traditional view of "property," as you suggest.

Definition of "Property"

The courts provide little guidance in the interpretation of the self-constructed property exception itself. In Steelcase, Inc. v. United States, 98-2 U.S.T.C. (CCH) ¶ 50,723 (6th Cir. Sept. 2, 1998), aff'g 95-2 U.S.T.C. (CCH) ¶ 50,336 (W.D. Mich. June 6, 1995), the court dealt with that taxpayer's reliance on the self-constructed property exception to claim ITC for the construction of a building. There, the building was originally designed for a particular layout by an architectural firm hired by the taxpayer, and work started on the foundation prior to 1986 by construction forces with which the taxpayer had contracted. Thereafter, in early 1986, the taxpayer halted work on the building, and directed the architect to redesign the building with a dramatically different configuration, but on the same plot of land. In ruling for Steelcase, the court there held that the costs incurred by the taxpayer both before and after the design change related to one property, not two separate properties.

Noting that the self-constructed property rule does not actually define property, the court rejected the government's suggestion that the rule requires substantial design changes to have been completed prior to 1986. Nonetheless, the court made clear its conclusion that the scrapping of plans did not alter the fact that those modifications concerned one property, the building it had started to build prior to 1986.

Our understanding of the [redacted] is that expansion of it, or replacements of it, add or substitute assets that

function with the existing [redacted], but that the addition or replacement of one portion of the [redacted] is not essential or integral to all other additions and replacements made thereafter. The issue here concerns the taxpayer's characterization of the "[redacted]" as the property for which it seeks application of the self-constructed property rule.

Nothing in the legislative history lends support for such an expansive reading as the one that the taxpayer takes. Explanations of this rule offered on the Senate and House Floor confirm this. These descriptions concerned whether the provision requiring a taxpayer to incur or commit the lesser of 5 percent or $1 million prior to January 1, 1986 was satisfied where an airplane manufacturer had, by that date, entered into binding contracts with third parties for the construction of aircraft subassemblies. The bill floor leaders stated that construction of the aircraft would be considered to have begun by the aircraft manufacturer when the subcontractors commenced physical construction of the subassemblies on behalf of the manufacturer pursuant to the binding written contract for an amount that exceeded 5 percent of the aircraft's cost. Since the subassemblies were to be included by the manufacturer in the construction of the completed aircraft, and were specifically ordered for it under a binding written contract, this commitment satisfied Act section 203(b)(1)(B)(i). 132 Cong. Rec. S 13898 (Sept. 27, 1986); 132 Cong. Rec. H 8356 (Sept. 25, 1986).

This explanation points out Congress' focus on self-constructed property as each property that is placed in service separately. In contrast, this taxpayer wishes to lump together all expenditures for properties that were placed in service between [redacted], and [redacted], regardless of whether the minimum expenditure or commitment for that property was made by December 31, 1985. As the below analysis bears out, the parts that are included as one property, for purposes of ITC, turns on which parts are essential to the activity for which they are used.

Section 48(a) defines "Section 38 property," the property for which the investment credit generally applied, in relevant part as follows:

> (A) tangible personal property (other than an air conditioning or heating unit), or
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> (B) other tangible property (not including a building or its structural components) but only if such property -

> (i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services . . . .

Section 48(a)(1). Treas. Reg. § 1.48-1(d)(4), promulgated under this section, provides that property is used as an integral part of a communications business if "it is used directly in the activity and is essential to the completeness of the activity."

Several cases amplify this theme. In Sealy Power, Ltd. v. Commissioner, 46 F.3d 382 (5th Cir. 1995), nonacq. on other grounds, 1995-2 C.B. 2, the court rejected the taxpayer's attempt to treat separately the component parts of an integrated electricity-generating facility for purposes of determining when it qualified for ITC. There, the court held that components are not considered placed in service separately from the system of which they are an essential part, relying on Rev. Rul. 73-518, 1973-2 C.B. 54, and Rev. Rul. 76-238, 1976-1 C.B. 55. Sealy Power, 46 F.3d at 389. The former ruling, concerning depreciation of an electrical transmission line, holds that such a line is first placed in service when the system of substations and the transmission line connecting them are first available for service. Likewise, Rev. Rul 76-238, concerns the individual units of production machinery and equipment acquired for use in a factory. This ruling holds that the machinery and equipment are first placed in service when they are installed in the production line, and that "line [is] available for the production of an acceptable product." See also, Consumer Powers Co. v. Commissioner, 89 T.C. 710 (1987) (reservoir for pumped storage hydroelectric plant not placed in service until other facilities integral to its use were placed in service).

Similarly, in Hawaiian Independent Refinery, Inc. v. United States, 697 F.2d 1063 (Fed. Cir. 1983), aff'g 82-1 U.S.T.C. (CCH) ¶ 9183 (Cl. Ct. 1982), cert. denied, 464 U.S. 816 (1983), the court had to apply the transitional rule from a prior restoration of the ITC provision. The taxpayer there contended that its oil refinery was a separate property from the tanker mooring facility and refined products pipelines that connected to the refinery. Concluding that the mooring facility, the product pipelines, and the refinery functionally formed a single property, the court affirmed the trial judge's approach. Refinery, 697 F.2d at 1069. The trial court's ruling held that the mooring facility and the product pipelines were integral to the refinery's manufacturing or production process, further explaining that

> if, as a practical matter, the facility could not function as designed without each of the components at issue, it is

> reasonable to treat them as parts of a single property . . . . Each of the offsite components is essential to the operation of the petroleum refinery -- the refinery could not function without a system for receiving the crude oil and removing and storing the completed products. . . . All were placed in operation concurrently.

Refinery, 82-1 U.S.T.C. (CCH) ¶ 9183.

At least one court has rejected a taxpayer's claim that a combination of multiple assets constitutes one property for ITC purposes, as the taxpayer appears to do here. In OKC Corp. v. Commissioner, 82 T.C. 638 (1983), the taxpayer claimed ITC for an oil refinery and an alkylation unit, a self-contained facility that chemically combines two gases into a high octane blending component that the refinery used to produce high octane gasoline. The alkylation unit could operate independently from the rest of the refinery.

In that case, similar to the instant situation, the taxpayer's claim relied upon transitional provisions excepting certain expenses from the repeal of the ITC by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. There, the taxpayer claimed that it had constructed a plant facility, comprising the refinery and the alkylation unit, where more than 50 percent of the depreciable basis of the plant facility was attributable to the fully-assembled refinery which the taxpayer had acquired prior to April 19, 1969. No work was performed on the alkylation unit until after April 19, 1969, so that the taxpayer would not qualify for ITC on the alkylation unit expenditures unless it and the refinery comprised one property, for purposes of the "plant facility rule." OKC Corp., 82 T.C. at 652-653.

The court rejected the taxpayer's argument, finding that the alkylation unit was independent and not essential to the operation of the refinery. Further, citing its operation for many years without the alkylation unit, the court found the refinery to constitute "an integrated processing or manufacturing system," and a separate property than the alkylation unit for purposes of the "plant facility rule." Id., 82 T.C. at 653-654. We note the similarity between the refinery unit in the OKC Corp. case and the taxpayer's preexisting telephone network that was already in service as of December 31, 1985, both of which constituted separate property from that which was constructed after the transition rules became effective.

These cases stand for the proposition that the "placed in service" date for property occurs when it and all components comprising the system of which it is an essential part are

available for use as intended. Nothing we have seen supports [redacted]'s claim that all [redacted] additions coming on line after 1985 comprise one property. Moreover, application of the taxpayer's position globally would have consumed any reasonable limitations of the self-constructed property rule for established businesses, since all post-1985 additions to operating capacity would qualify as transition property if the definition of property is, as the taxpayer urges, so expansive as to include all pre-termination, as well as post-termination assets that provide this capacity.

As we understand it, [redacted] constructed additional [redacted] to meet various needs, and placed in service the component parts of such facilities as they became available for service. We believe that further factual development described herein will make clear that the post-1985 [redacted] additions actually constituted many distinct properties, inasmuch as their integration into the [redacted] did not all take place at one time, nor was each addition integrally related to all other property additions to the [redacted].

2. Beyond fitting within one of the specific exceptions of the transition rules, in order for property to qualify as transition property under section 49(e)(1), the taxpayer must place it into service prior to certain dates, referred to in Act section 203(b)(2) as the "applicable date." These applicable dates depend largely upon the class life of the property.[5] Generally, in determining whether property is transition property, i.e., whether it is property to which the amendments made by Act section 201 (repealing ACRS) do not apply, Act section 203(b)(2) sets forth the "applicable date" by which taxpayers must have placed such property in service to entitle them to claim ITC. For property with a class life of less than 7 years, Act section 203(b)(2)(C), as modified by section 49(e)(1)(C), is used to determine either the class life to be used and/or the applicable date by which the property must be placed in service.

Specifically, section 49(e)(1)(C) applies Act section 203(b)(2) to transition property with a class life of less than 7 years, and modifies it to define the applicable dates for transition property with (I) a class life of less than 5 years as July 1, 1986, and (II) a class life of at least 5 years, but less than 7 years as January 1, 1987. Inasmuch as this transition

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[5] For residential rental property and nonresidential real property, Act section 203(b)(2)(B) sets the applicable date without reference to class life.

rule generally applies Act section 203(b)(2), Act section 203(b)(2)(C)(i) sets the class life for determining the applicable date for computer-based telephone central office switching equipment as 6 years. [redacted]

Unlike the taxpayer's prior basis for its claim that the assets acquired qualify as transition property upon the characterization of the [redacted] as a supply or service contract under Act section 204(a)(3), the self-constructed property exception is governed by Act section 203(b)(2)(A), as modified by section 49(e)(1)(C)(ii)(II), which sets forth the applicable date of property with a class life of at least 5 years, but less than 7 years as January 1, 1987. Since this date precedes the periods at issue, none of the costs incurred for property placed in service after December 31, 1986, qualify for ITC. Nor in its Second Supplemental Protest has the taxpayer set forth a basis upon which it can meet the placed in service requirements of Act section 203(b)(2) or section 49(e)(1)(C).

For additions to the telephone network made by the taxpayer that involve other than computer-based telephone central office switching equipment, the general rule of Act section 203(b)(2)(C), defining class lives by reference to section 168(g)(3)(B) (1986). That section, by reference to several subparagraphs of section 168(e)(3), set the class life of "any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications" at 24 years. By application of the rules set out at Act section 203(b)(2)(A), the applicable date for such property is January 1, 1991. Without any detail on the nature of the property (i.e., the description of the property, the date on which it was placed in service, and the description of all other property integral in making a property available for service, it is impossible to evaluate the bona fides of the claim based upon the taxpayer's Second Supplemental Protest.

3. We recommend further development of several issues concerning whether any property placed in service by the taxpayer qualifies as self-constructed property eligible for ITC. In several cases, we believe such factual development necessary to enable us to confirm our understanding, and to defend against the vague factual allegations made by the taxpayer in its Second Supplemental Protest.

(b)(5)(AC), (b)(7)a

[redacted]

Please refer all questions regarding this memorandum to William Davis of this office at (303) 844-3258.

MARTIN B. KAYE
District Counsel

By: _____
JERRY L. LEONARD
Assistant District Counsel